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BOARDS OF DIRECTORS A NEW STANDARD OF CARE

*by John A. Calfas**

I. INTRODUCTION

The duties of directors and the standard of care which they must employ in discharging them have been the subject of many articles in both legal and business journals. The role of a director in a modern, large, and publicly held corporation has not been understood. Legislators, courts, and businessmen have had—in most cases—conflicting views. Some of these views will be explored in this article so that the new California law on the subject may be seen in perspective. The new general corporation law (GCL),¹ which will become effective on January 1, 1977, recognizes the realities of the role of the director and sets forth a standard of care that directors will appreciate and understand. In fact, a number of corporations currently incorporated under the laws of Delaware may be urged by directors—especially the outside directors²—to reincorporate in California.

The role of the director as set forth by the GCL in sections 300 and 309 can be briefly summarized as follows: (1) The director shall manage the corporation but need not become involved in its day-to-day operations;³ (2) The director shall serve in good faith and in the best interests of the corporation, exercising such care, including reasonable inquiry, as an ordinary prudent person in a similar position would exercise under similar circumstances;⁴ and (3) The director shall be

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1. Law of Sept. 12, 1975, ch. 682, § 7, [1975] Cal. Stat. —. [hereinafter cited as GCL]. This new general corporation law will take effect on January 1, 1977. Amendments have been made to the GCL prior to its effective date by enactment of the technical amendments bill, August 27, 1976, ch. 641, [1976] Cal. Stat. —. These amendments are reflected in this article where relevant.

2. Unless otherwise noted, this article deals with the role of the outside director of large, publicly held corporations. "Inside" directors are those directors who are or were full-time employees of the corporation.

3. GCL, *supra* note 1, § 300(a).

4. *Id.* § 309(a).

entitled to rely on people (employees, outside experts, and fellow directors) whom he believes to be competent.⁵

The exact language and history of these sections will be discussed at length below; but first some of the background leading to the present identity crisis of the director should be considered. This examination will be made from the point of view of the legislatures, courts, and businessmen involved.

II. BACKGROUND

For decades, directors have been told by legislators that directors *shall manage* the business and affairs of the corporation. The current California law is substantially to that effect.⁶ Likewise, the courts have rarely attempted to define the duties of directors and to tell them *what* they must do; rather, the courts have discussed the standard of care that the directors must use in discharging their legal responsibility to *manage the business* of the corporation.

While the legislators and courts have told directors that they *shall manage*, the business community has been truly confused as to the role a director should play in the management of the corporation.⁷ Few persons involved with larger, publicly held corporations believe that di-

5. *Id.* § 309(b).

6. CAL. CORP. CODE ANN. § 800 (West Supp. 1975). Section 800 of the California Corporation Code provides in part:

[A]ll corporate powers shall be exercised by or under authority of, and the business and affairs of every corporation shall be controlled by, the board

Id. GCL, *supra* note 1, § 300(a) provides in part:

[T]he business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board.

Id.

7. The 1962 study on corporate directorship practices issued by the National Conference Board and the American Society of Corporate Secretaries listed seven areas of responsibility in which the board should function:

1. To establish the basic objectives and broad policies of the corporation.
2. To elect the corporate officers, advise them, approve their actions, and audit their performance.
3. To safeguard and approve changes in the corporate assets (issuance of securities, pledge of assets on loans, declaration of dividends, and conveyance of property).
4. To approve important financial matters (such as budgets, capital appropriations, officers' pay, financial audits), and to see that proper annual and interim reports are given to stockholders.
5. To delegate special powers to others to sign contracts, open bank accounts, sign checks, issue stock, make loans, and such other activities as may require board approval.
6. To maintain, revise, and enforce the corporate charter and by-laws.
7. To perpetuate a sound board through regular elections and the filling of interim vacancies.

CONFERENCE BOARD, INC., CORPORATE DIRECTORSHIP PRACTICES 48 (1962).

rectors can or do manage their respective corporations. For example, when Arthur J. Goldberg resigned from the board of Trans World Airlines, he stated: "Contrary to legal theory, the board of directors of most of our larger companies do not in fact control and manage their companies, nor are they equipped to do so."⁸ Other businessmen have expressed the same views. They contend the board is only necessary to determine to whom control of the day-to-day corporate affairs should be delegated. John R. Bunting, Jr., Chairman, First Pennsylvania Banking and Trust Company and Chairman, First Pennsylvania Corporation, stated that:

[T]he directors influence management by embodying attitudes and points of view. *Those directors who try to help management manage are making a very serious mistake, in my view.* And any management that lets them do that is too weak to tolerate. But they do influence the management in subtle ways.⁹

Myles L. Mace, while Professor of Business Administration at Harvard University, wrote extensively on the role of directors. In his book, *Directors: Myth and Reality*,¹⁰ and in his article, *The President and the Board of Directors*,¹¹ he stated that, contrary to the popular view in business journals and publications, the directors do *not* establish objectives, ask discerning questions, or select the president.¹² Mr. Mace concluded that "most presidents and outside board members agree that the role of directors is largely advisory and not of decision-making nature."¹³ In addition to providing advice and counsel, Mr. Mace

8. Goldberg, *Debate on Outside Directors*, N.Y. Times, Oct. 29, 1972, § 3 (Business and Financial Section), at 1.

9. The Conference Board, *The Board of Directors: New Challenges, New Directions*, N.Y. CONFERENCE BOARD 6, at 39 (Nov. 8, 1971) (emphasis added) [hereinafter cited as CONFERENCE BOARD].

10. M. MACE, *DIRECTORS: MYTH AND REALITY* (1971).

11. Mace, *The President and the Board of Directors*, 50 HARV. BUS. REV. 37 (1972).

12. *Id.* at 41-43.

13. *Id.* at 38. Other assessments of the board of directors' role were espoused by persons attending a conference on November 18, 1971, sponsored by The Conference Board. The views of some of these people, directors of major corporations, follow:

—Gustave L. Levy, Senior Partner, Goldman, Sachs & Co.: "Unfortunately, many chief executives regard the board as a necessary evil to be used only as legal requirements dictate." CONFERENCE BOARD, *supra* note 9, at 6.

—Harleston R. Wood, Chairman of the Board and President, Alan Wood Steel Company, stated that he felt that the board "should select the right guy and turn it [the corporation] over to him. Then he [the president] comes to the board with policies or strategies for their approval." *Id.* at 23. The primary function of the board in the normal publicly held company is "to make sure the right man is running the business and to make sure that he has somebody there if he gets run over by a truck. . . ." *Id.* at 25.

—John R. Beckett, Chairman and President, Transamerica Corporation, says with respect to most of the boards on which he has served, they "don't know exactly what they are supposed to do." At Transamerica the board agrees, once a year, on

found that boards do provide some discipline value and do act in crisis situations. Mr. Mace's conclusion that directors do act in crisis situations is true—at least in some cases. For example, the directors of Gulf Oil Corporation, after a marathon 2-day board meeting, accepted the resignations of four top officers. An editorial in *Business Week*,¹⁴ however, indicated that the Gulf Oil directors should get no medals. They simply did what directors are supposed to do—call management to account.

III. THE GCL

A. *The Director's Duty*

Perhaps the real reason for this lack of consensus on the position of the board is the failure to deal with the reasons for the existence of a board of directors. Whether one assumes that boards of directors have existed for 4,000 years¹⁵ or are a modern invention, the fact remains that the question of the director's duty has not yet been answered. In specific cases, directors perform specific duties imposed by law or otherwise. That, however, does not justify the existence of boards of directors; the president or other employees of the corporation could have performed most of the director's duties. If directors are to *manage*, perhaps they should have an independent staff. If they are to do less than manage, then the legislature should reconsider the text of the GCL and further reduce the responsibilities of directors.

Section 300(a) provides that the business of the corporation shall be managed by or *under the direction* of the board. It may be argued that "under the direction" of the board means something different than "under the authority" of the board, the latter phrase constituting the language of the present California statute.¹⁶ Nonetheless, the distinction between (1) the directors shall manage, and (2) the corporation shall

what it is supposed to do. Mr. Beckett believes that "boards of directors should have job descriptions. . . ." *Id.* at 26.

A similar disenchantment with the board of directors as managers was aired by Norton Simon, retired founder of Norton Simon, Inc. He openly complained about the lack of information received by him and other directors of Burlington Northern. In fact, he voted against the management-proposed slate of directors, including himself. He is quoted as saying, "[b]oards of companies have gone dead." *FORBES*, June 15, 1973, at 92.

14. *BUS. WEEK*, Feb. 2, 1976, at 74.

15. The corporate form of business has been with us for many years. In 2083 B.C., the Code of Hammurabi gave the Babylonians a type of special partnership with long life through which business could be carried on for years. See H. KOONTZ, *THE BOARD OF DIRECTORS AND EFFECTIVE MANAGEMENT* (1967).

16. *CAL. CORP. CODE ANN.* § 800 (West Supp. 1975).

be managed under the "authority" or "direction" of a board, is difficult to comprehend.

In an effort to define the role of the director in different terms than those provided for in prior law, the California Legislature added the last sentence to section 300(a) of the GCL, which provides in part that the board "may delegate the management of the day-to-day operation . . . provided that the business . . . shall be managed . . . under the ultimate direction of the board."¹⁷ It is unfortunate that this sentence was added at the last moment. Businessmen and others may be fond of trying to distinguish between "day-to-day operations" and all other operations, but the courts may have difficulty in drawing this distinction. This addition to section 300(a) contributes nothing to clarify the duty of the board. Any guidance on the questions of the duties of directors will have to be sought elsewhere.

California courts have said that the authority of the directors in the conduct of the business of a corporation must be regarded as absolute when they act within the law.¹⁸ Further, directors and officers in a fiduciary relationship with the corporation and its stockholders have a duty to promote the interests of the corporation and its stockholders.¹⁹ This duty extends to all stockholders, including minority stockholders.²⁰

The provisions of the Civil Code relating to trustees²¹ are applicable to directors and officers of corporations as fiduciaries to the corporation and its stockholders.²² In *Burt v. Irvine Co.*,²³ the court stated:

17. The last sentence of the GCL, *supra* note 1, § 300(a) reads as follows:

The board may delegate the management of the day-to-day operation of the business of the corporation to a management company or other person provided that the business and affairs of the corporation shall be managed and all corporate powers shall be exercised under the ultimate direction of the board.

Id. The Committee on Corporations of the State Bar of California in cooperation with the Assembly Select Committee on the Revision of the Corporations Code (Honorable John T. Knox, Chairman), distributed to local bar representatives various "Exposure Drafts" and the Preprint Bill version of the then Proposed New General Corporation Law for comment. The sentence quoted above was not included; therefore, it must have been added very late in the drafting process.

18. *Fairchild v. Bank of America*, 192 Cal. App. 2d 252, 13 Cal. Rptr. 491 (1961).

19. *See, e.g., Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); *Laurence v. I.N. Parlier Estate Co.*, 15 Cal. 2d 220, 100 P.2d 765 (1940); *Sheppard v. Wilcox*, 210 Cal. App. 2d 53, 26 Cal. Rptr. 412 (1962); *Kennerson v. Burbank Amusement Co.*, 120 Cal. App. 2d 157, 260 P.2d 823 (1953).

20. *See, e.g., Burt v. Irvine Co.*, 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965).

21. CAL. CIV. CODE § 2228 *et seq.* (West 1970).

22. *Austin v. Turrentine*, 30 Cal. App. 2d 750, 87 P.2d 72, *rehearing denied*, 30 Cal. App. 2d 766, 88 P.2d 178 (1939).

23. 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965).

It is hornbook law that directors, while not strictly trustees, are fiduciaries, and bear a fiduciary relationship to the corporation, and to all the stockholders. They owe a duty to all stockholders, including the minority stockholders, and must administer their duties for the common benefit. The concept that a corporation is an entity cannot operate so as to lessen the duties owed to all of the stockholders. Directors owe a duty of highest good faith to the corporation and its stockholders.²⁴

A great deal has been written on the subject of to whom directors owe a duty. In 1932, Professors Berle and Dodd appeared to accept the concept that directors were trustees, and the only remaining question was for whom.²⁵ Berle originally argued that management was primarily a trustee for stockholders, while Dodd insisted that management was a trustee not only for its stockholders, but also for its employees, customers, and the area of business on which they had an impact.

In 1968, Professor Berle discussed his theory dealing with the two basic categories of law affecting corporations.²⁶ The first category was defined as the familiar statutes and decisions. The second category, "inchoate" law, was related by Berle to the duties of the corporation, deriving not from statutes or court decisions, but arising from the impact of social and economic situations foreseeably resulting from a corporate course of action. He views the corporation's responsibilities as being first, to the markets relying on it for supply, and, second, to producing the goods with a minimum of waste while avoiding water and air pollution and the debasement of the landscape. He pointed out that corporations ought to keep their employments continuous and that directors "ought at once to appoint an 'internal review committee' . . . to examine [the corporation's] operations" to provide remedies or change policies as needed.²⁷ He also pointed out that large corporations should be cognizant of their social responsibility vis-à-vis television. He submitted that corporations can determine what will be shown on television and, therefore, have an appreciable impact upon the habits and culture of Americans.

Professor Berle is joined by many writers who urge that the role of the corporation in society is broad and, therefore, directors must be respon-

24. *Id.* at 850, 47 Cal. Rptr. at 406.

25. Berle, *For Whom Corporate Managers are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932); Dodd, *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

26. Berle, *Corporation Decision-Making and Social Control*, 24 BUS. LAWYER 149 (1968).

27. *Id.* at 153.

sible to constituencies other than just their shareholders. Other writers suggest that various "special interest" groups should be represented on boards. Finally, others suggest that the job of selecting directors is too important to be left to the shareholders.

Professor Schwartz calls for public representatives on the boards and the furnishing of staff and money to such public representatives so that public representatives would not lack the means to do the job.²⁸ He suggests the possibility of compiling a list from which independent directors could be selected. He suggests that industry, government, and the public would cooperate in assembling this list, and he endorses the idea of establishing a private or governmental panel to oversee boards of directors and to insure the protection of shareholder interests.

There are, of course, others who argue that the role of the corporation (and necessarily its directors) should not be expanded. For instance, Professor Manne does not believe that the claims for corporate responsibility are proper. He asserts that corporate executives should only be urged to meet their social responsibilities in ways that traditional economic theory suggests.²⁹

The question of whether directors are trustees for anyone or fiduciaries for the shareholders has most often been discussed in the context of the conflict of interest of the director. The subject was thoroughly discussed in 1966 by Harold Marsh when he inquired as to whether directors were trustees for anyone, and reviewed the development of the law involving conflict of interest and corporate morality.³⁰ Marsh noted that in 1880 the law seemed to be clear that any contract between a director and his corporation was voidable without regard to fairness or manner of approval. By 1910, the general rule seemed to be that a contract between a director and the corporation was valid if approved by a disinterested party and was fair. He noted that by 1960 all transactions were not automatically voidable whether or not there was a disinterested majority, but that the courts would review the fairness of the transaction.

28. Schwartz, *Corporate Responsibility in the Age of Aquarius*, 26 BUS. LAWYER 513 (1970).

29. Manne warns that "[i]f Ralph Nader's scheme can be made politically popular, every corporation in America will have a public observer in the executive suite." Manne, *The Myth of Corporate Responsibility-or-Will the Real Ralph Nader Please Stand Up?*, 26 BUS. LAWYER 533, 539 (1966).

30. Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAWYER 5 (1966).

The confusion as to the scope and extent of directorial duties is real. Most corporate statutes provide that directors *shall manage*. Many directors and other businessmen recognize that directors *cannot* (or should not) *manage*. As noted earlier, there is little or no agreement among businessmen as to what directors should do. Some directors view boards as being dead. Some writers in legal and business journals suggest that directors be trustees (for stockholders, labor, suppliers, markets, or society as a whole?) and some argue that directors are not trustees. Others write of corporate responsibility without identifying the group within the corporate structure that should be responsible; should it be the shareholders, the board, the executive committee, the chief executive officer, or the top ten officers? The fact that the confusion is real is of great importance to California lawyers and courts in trying to deal with the GCL.

B. *The Standard of Care*

The standard of care to be exercised by a director has been a matter that legislatures and courts have addressed themselves to with particularity. Businessmen, on the other hand, have viewed the matter simply: the director's performance should be viewed in light of the circumstances. The fact that there may be only four meetings a year of one to two hours each, the fact that "management" or the Chief Executive Officer furnishes limited information, the fact that there is no Audit Committee, and the fact that the Executive Committee consists solely of inside directors are all viewed by most outside directors as part of the circumstances to be considered in evaluating the director's performance.

The significant and major change effected by the GCL—as far as directors are concerned—relates to the standard of care to be exercised by a director in fulfilling his duty. Under section 309(a) of the GCL, an affirmative statement is made as to the standard of care under which a director shall be judged in performing his duties. Section 309(a) states that the director must act

in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.³¹

There are no fundamental changes included in this section. Under present California law, a director must have exercised his power "in

31. GCL, *supra* note 1, § 309(a).

good faith, and with a view to the interests of the corporation."³² The section should still be viewed with care. In comparison with the statutory standards imposed in other states, the GCL avoids the use of terminology such as skill or diligence. For example, in Minnesota a director is required to discharge his duties "with that diligence and care which ordinarily prudent men would exercise under similar circumstances in like positions."³³ In Idaho, the statutory language reads "with that diligence, care, and skill"³⁴ In Maine, a director shall exercise his duties "with that degree of diligence, care and skill"³⁵

The GCL is similar to section 35 of the Model Business Corporation Act (MBCA).³⁶ The drafters of the MBCA studiously avoided the use

32. CAL. CORP. CODE ANN. § 820 (West 1955).

33. MINN. STAT. ANN. § 301.31 (1969).

34. IDAHO CODE § 30-142 (1967).

35. ME. REV. STAT. ANN. tit. 13-A, § 716 (1964).

36. The full text of section 35 of The Model Business Corporation Act [hereinafter cited as MBCA] is found in Committee on Corporate Laws, *Changes in the Model Business Corporation Act*, 30 BUS. LAWYER 501, 502-03 (1975). The full text follows:

All corporate powers shall be exercised by or under authority of, and the business and affairs of a corporation shall be managed under the direction of, a board of directors except as may be otherwise provided in this Act or the articles of incorporation. If any such provision is made in the articles of incorporation, the powers and duties conferred or imposed upon the board of directors by this Act shall be exercised or performed to such extent and by such person or persons as shall be provided in the articles of incorporation. Directors need not be residents of this State or shareholders of the corporation unless the articles of incorporation or by-laws so require. The articles of incorporation or by-laws may prescribe other qualifications for directors. The board of directors shall have authority to fix the compensation of directors unless otherwise provided in the articles of incorporation.

A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances. In performing his duties, a director shall be entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, in each case prepared or presented by:

(a) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented,

(b) counsel, public accountants or other persons as to matters which the director reasonably believes to be within such person's professional or expert competence, or

(c) a committee of the board upon which he does not serve, duly designated in accordance with a provision of the articles of incorporation or the by-laws, as to matters within its designated authority, which committee the director reasonably believes to merit confidence,

but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted. A person who so performs his duties shall have no liability by reason of being or having been a director of the corporation.

A director of a corporation who is present at a meeting of its board of directors at which action on any corporate matter is taken shall be presumed to have assented to the action taken unless his dissent shall be entered in the minutes of the meeting or unless he shall file his written dissent to such action with the

of the words "skill" and "diligence," noting that "in point of fact, skill, in the sense of technical competence in a particular field, has never been regarded as a qualification for the office of director."³⁷ However, section 309(a) of the GCL differs in one material respect from the comparable provision of section 35 of the MBCA. That difference is that *California adds a duty to make a "reasonable inquiry."* It may well be argued that the MBCA has implicit in its language an affirmative duty to make reasonable inquiry if any director is to use "such care as an ordinarily prudent person in a like position would use under similar circumstances." Furthermore, federal and state securities laws have imposed affirmative duties of inquiry upon directors and California courts may follow some of the federal securities law cases³⁸ and significantly expand the reasonable inquiry requirement of California's section 309(a).

Courts have discussed the notion that directors are trustees or fiduciaries with an affirmative duty to diligently pursue the interests of the shareholders. The courts have spoken, often eloquently, on the standard of care which directors must employ in fulfilling these duties but—until recently—they have recognized that those in business are going to make mistakes when they make business decisions. Thus, Professor Bishop, who has written extensively on the subject of directors' liability and the indemnification of directors, concludes from his extensive research that the courts are in fact applying a standard of care with respect to directors which calls for something *more than mere negligence*.³⁹

secretary of the meeting before the adjournment thereof or shall forward such dissent by registered mail to the secretary of the corporation immediately after the adjournment of the meeting. Such right to dissent shall not apply to a director who voted in favor of such action.

Id. The Committee on Corporate Laws of the Section of Corporations, Banking and Business Law of the American Bar Association adopted section 35 of the MBCA on September 21, 1974, after first publishing the proposed revision in Committee on Corporate Laws, *Changes in the Model Business Corporation Act*, 29 BUS. LAWYER 947, 949-51 (1974).

37. Committee on Corporate Laws, *Changes in the Model Business Corporation Act*, 30 BUS. LAWYER 501, 505 (1975).

38. According to *Business Week* magazine, two outside directors of Sterling Homex are being sued by the Securities and Exchange Commission (SEC) on the ground that their performance as directors was not adequate. According to the SEC, the two defendants had no knowledge of fraud and in fact were intentionally deceived by the company insiders. The SEC charges that as sophisticated businessmen, they should have probed more deeply. BUS. WEEK, Feb. 2, 1976, at 56.

39. Bishop, Jr., *New Problems in Indemnifying and Insuring Directors: Protection Against Liability Under the Federal Securities Laws*, 1972 DUKE L.J. 1153; Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968).

Indeed, it is only in rare cases, excluding, of course, conflict of interest cases, that a court will find a director liable because he failed to manage, act in good faith, or act with that degree of diligence, care, and skill as an ordinarily prudent person would use.⁴⁰

Thus, it has been noted that in order to warrant interference by a court in favor of minority stockholders, a case must be established which plainly shows that the board's action is so far opposed to the true interests of the corporation itself as to lead to the clear inference that no one thus acting could have been motivated by any honest desires to secure such interest. Instead, it must be found that the action was taken with an intent to subserve some outside purpose, regardless of the consequences to the corporation.⁴¹

Historically, the courts have used the business judgment rule in determining the standard of care to be exercised by a director:

The test in each case is whether corporate action is the result of the exercise by the directors of their unbiased judgment in determining that such action will promote the corporate interests.⁴²

In the absence of fraudulent conduct on the part of those who have been lawfully entrusted with the management and conduct of the corporation's affairs, the authority of a corporation's directors in conduct of a corporation's business must be regarded as absolute. The court, in *Wall v. Board of Regents of University of California*,⁴³ stated:

The board of regents constitute a corporation and from the petition it would appear that they are a normally functioning body. This being so, this court has no right to interfere with its government. The conclusions reached by the regents are final in the absence of fraud or oppression. . . . The authority of the directors in the conduct of the business or a corporation must be regarded as absolute when they act within

40. See note 42 *infra* and accompanying text.

41. Where corporate directors are not guilty of any mismanagement in direction of corporate affairs, the corporation has no claim against them for breach of duty toward the corporation, and consequently a stockholder could have no claim. *Kaiser v. Easton*, 151 Cal. App. 2d 307, 311 P.2d 108 (1957).

42. *Chelrob, Inc. v. Barrett*, 293 N.Y. 442, 460, 57 N.E.2d 825, 833, *rehearing denied*, 293 N.Y. 859, 59 N.E.2d 446 (1944). Another oft quoted statement of the business judgment rule follows:

The internal affairs, question of policy of management, and expediency of contracts of a corporation are subject to the control of a board of directors, and in so far as those directors are honest, capable and independent, their judgment is final.

Turner v. American Metal Co., 268 App. Div. 239, 259, 50 N.Y.S.2d 800, 819 (1944). See also H. BALLANTINE, *BALLANTINE ON CORPORATIONS* 160, 161 (rev. ed. 1946).

43. 38 Cal. App. 2d 698, 102 P.2d 533 (1940).

the law. The court cannot substitute its judgment for that of the directors.⁴⁴

Thus, even though a director may be remiss, he does not fail to meet his duties except in limited cases. The rule exempting officers of corporations from liability for mere mistakes and errors of business judgment does not apply where the loss is the result of failure to exercise proper care, skill and diligence.⁴⁵ As stated by the court in *Burt v. Irvine Co.*:⁴⁶

The question is frequently asked, how does the operation of the so-called "business judgment rule" tie in with the concept of negligence? There is no conflict between the two. When courts say that they will not interfere in matters of business judgment, it is presupposed that judgment—reasonable diligence—has in fact been exercised. A director cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment. Courts have properly decided to give directors a wide latitude in the management of the affairs of a corporation provided always that judgment, and that means an honest, unbiased judgment, is reasonably exercised by them.⁴⁷

Additionally, the California courts have interpreted the term "judgment" to mean diligence, and have looked at the director as having some duty to make a reasonable inquiry.⁴⁸ The courts have failed, however, to either find the power or exercise their right to intermeddle with the internal affairs of the corporation.

C. Types of Information and Exculpation

Perhaps the most significant change in the corporate law is in section 309(b) of the GCL,⁴⁹ which expands both the kinds and sources of

44. *Id.* at 699, 102 P.2d at 534.

45. As Fletcher states:

Directors are not merely bound to be honest; they must also be diligent and careful in performing the duties they have undertaken. They cannot excuse imprudence on the ground of their ignorance or inexperience, or the honesty of their intentions; and if they commit an error of judgment through mere recklessness, or want of ordinary prudence and skill, the corporation may hold them responsible for the consequences.

3 FLETCHER, CYCLOPEDIA OF CORPORATIONS 628 (1965), quoting original work of Fletcher as recited in *Wangrow v. Wangrow*, 211 App. Div. 552, 207 N.Y.S. 132, 136 (1924).

46. 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965).

47. *Id.* at 852-53, 47 Cal. Rptr. at 408, quoting *Casey v. Woodruff*, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944).

48. See note 46 *supra*.

49. Following is the text of GCL, *supra* note 1, § 309(b):

information that a director may rely upon in performing his duties. Under present law, the *kinds* or scope of the information (as well as the *sources*) upon which a director could rely have been limited; a director may rely on financial statements furnished by the president or chief financial officer or certified public accountant "selected with reasonable care."⁵⁰ Under section 309(b), as to *kinds* of information that a director may rely upon, it would appear to be clear that the legislature intended that it be *any* information, opinions, reports, or statements—not just financial statements—from independent accountants.⁵¹

A comparison of the statutes in other jurisdictions leads to the conclusion that section 309(b) of the GCL is broader than any other state's statute, with one exception, as to the *kinds* of information and the *sources* of information upon which a director may rely.⁵² The one

(b) In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by:

(1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented,

(2) Counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence, or

(3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence,

so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefore is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.

50. CAL. CORP. CODE ANN. § 829 (West Supp. 1975).

51. Perhaps the idea that directors may rely on employees of the corporation is not so new after all. Consider the case of *Dovey v. Cory*, [1901] A.C. 477. Mr. Dovey was the liquidator of the National Bank of Wales, Limited, and brought suit against Mr. Cory, one of the outside directors. It was not disputed that from 1884 to 1890 dividends were illegally and improperly paid out of capital, and, under the applicable law, directors were personally liable. Nor was it disputed that bad debts had not been written off and that the earnings were fraudently overstated by the chairman and the general manager in such a manner that the fraud was not promptly discovered by the outside auditors. When the auditors did discover the overstatements of net income, the warning letters from the auditors were "never suffered to reach" the outside director. Lord Dovey spoke for the House of Lords when he said:

I think the respondent [the defendant outside director] was bound to give his attention to and exercise his judgment as a man of business on the matters which were brought before the board at the meetings which he attended, and it is not proved that he did not do so. But I think he was entitled to rely upon the judgment, information, and advice of the chairman and general manager, as to whose integrity, skill and competence he had no reason for suspicion.

Id. at 492.

52. In New York, Georgia, and Tennessee, a director may rely on financial statements furnished by stated officers or independent accountants. The New York statute contains no provision requiring that the independent accountants be selected with reasonable care. The New York statute provides:

exception is Florida, which in 1975 enacted section 607.111 of its Corporation Act.⁵³ The Florida statute is essentially a word-for-word copy of section 35 of the MBCA.⁵⁴ California's section 309 is also patterned after the MBCA.⁵⁵ Under California and Florida law and under section 35 of the MBCA and probably under most prevailing law, a director may not rely upon any information from any source (no matter how competent or reliable otherwise) if the director has knowledge that would cause such reliance to be unwarranted. The attitude of California courts as to whether actual or imputed knowledge (on a theory of negligence or deputizing) will be required remains to be seen.

IV. APPLICATION OF THE GCL

In light of the confusion as to the duties of directors, the California Legislature has taken a bold step in redefining the standard of care which directors must employ in discharging their duties. The entire thrust of this section seems clear: The director of a California corpora-

In discharging their duties, directors and officers, when acting in good faith, may rely upon financial statements of the corporation represented to them to be correct by the president or the officer of the corporation having charge of its books of accounts, or stated in a written report by an independent public or certified public accountant or firm of such accountants fairly to reflect the financial condition of such corporation.

N.Y. BUS. CORP. LAW § 717 (McKinney 1963); *accord*, GA. CODE ANN. § 22-713 (1970); TENN. CODE ANN. § 48-813 (Supp. 1975). In Michigan, a director may rely upon (i) the opinion of counsel, (ii) the report of an independent appraiser selected with reasonable care, and (iii) financial statements. MICH. STAT. ANN. § 21.200(541) (1974). In Ohio, a director may rely upon (i) the books and records of the corporation, (ii) reports *made by employees selected for the purpose with reasonable care*, and (iii) financial statements prepared by certain officers or accountants. OHIO REV. CODE ANN. § 1701.59 (Supp. 1974) (emphasis added). In Delaware, a director may rely upon (i) the books of account, (ii) reports made by any of the corporation's officers, (iii) reports made by independent certified public accountants, (iv) appraisers selected with reasonable care, and (v) other records of the corporation. DEL. CODE ANN. tit. 8, § 141(e) (1975).

53. FLA. STAT. ANN. § 607.111 (Supp. 1975).

54. *See* note 36 *supra*.

55. The exculpatory language in the GCL, *supra* note 1, § 309(c), provides that a person "who performs his duties as director . . . shall have no liability based upon any alleged failure to discharge the person's obligations as a director." The comparable provision of section 35 of the MBCA provides that "[a] person who so performs his duties shall have no liability by reason of being or having been a director of the corporation." *See* note 36 *supra*. The Florida provision is substantially similar. It appears that the language of section 35 of the MBCA is broader and that a California court may, under California's subdivision (c), limit the exculpatory language to acts of omission.

tion has one primary obligation, and that is to rely upon *competent people*. There are, however, some concerns.

The inside directors have a problem. Most of the reports and opinions received by a board are, in whole or in part, prepared by fellow employees, some of whom may be co-directors. The Vice President on the board may know a great deal (or may have ample information to indicate the need for reasonable inquiry) about the reliability and competence of his fellow Vice President who is also a co-director and competitor for the job of President. Under the statute his duty is clear: Do not rely upon reports or opinions. In the real, day-to-day corporate world, that may be most impolitic. The problem of inside directors is not a legal one; it is a practical one.

All directors will have some problems with the affirmative duty to make an inquiry. The affirmative duty to make an inquiry is new to California and does not appear in the MBCA or the Florida equivalents of section 309 of the GCL. Perhaps the duty was always with the director under California law. Certainly, a California director could not breach his fiduciary duty and then claim ignorance in defense.⁵⁶

The duty of inquiry should be limited by the courts (as called for by the statute) to comparisons to ordinarily prudent persons in a like position under similar circumstances (i.e., what would a prudent director inquire about in this kind of a situation?). Even with such a limitation, it would appear that in today's society every director of a multinational corporation should be inquiring about bribes to domestic or foreign persons, "laundered" money for political or other purposes, illegal political contributions of all sorts, the operation of the "black cash" system in certain of the company's foreign subsidiaries, and the compliance (or the refusal to comply) with Arab black lists.

From a pure monetary standpoint, a director could reasonably argue that a \$10-\$12 million slush fund for a large multinational corporation was not fiscally material. If the director views his role as strictly achieving financial goals and limits his inquiry to those areas, then it would be reasonable for a director to defend himself with the argument that a small bribe wasn't financially important, and, therefore, he should not be held accountable. Society, whether through the press, the SEC, shareholder suits, or otherwise, is saying to directors that they must serve as the conscience of the corporation and that they cannot brush aside what some might term to be "petty bribery."

56. *Sheppard v. Wilcox*, 210 Cal. App. 2d 53, 26 Cal. Rptr. 412 (1962).

The greatest concern will be the determinations of the courts as to the evidence that will be allowed regarding the reliability and competence of the various corporate employees and others upon whom the directors relied in a given case. The director *must believe* that the persons in question were reliable and competent.⁵⁷ Certainly the courts are going to require that a director have a basis for his belief. The early versions of section 309(b) provided that the director must "reasonably" believe. The courts and the draftsmen will certainly not accept less of a director. This may in fact present some problems. Some examples might demonstrate the concern.

If the Chairman of the Board called upon the Vice President to present a budget on a proposed new plant in Michigan, will the courts permit a director to rely upon the Chairman's statement that the Vice President is in fact competent, or must the directors have some supporting evidence of competence? In reviewing the proposed budget by the Vice President, are the directors to inquire as to the support obtained by him in the preparation of the report as a matter of determining his competence? For example, are the directors to be required to inquire as to the tax analysis prepared by or for the Vice President in connection with the operation of the new plant?

If the Chief Executive Officer (CEO) presents, but does not prepare, the forecast for the following year(s), what should the directors do? Should the directors' inquiry be directed at the competence of the CEO to prepare forecasts or rather to his competence in selecting competent people to prepare forecasts? In most companies the forecasts or budgets include the input of many people; must the competence of each be examined? How would the offensive and defensive strategies be influenced if section 309 of the GCL were applicable to (i) the Douglas Aircraft Company, Inc. suit where it was alleged that the profit forecast was materially misleading,⁵⁸ (ii) the Penn Central litigation where it appears that the forecasting of cash flow was materially in error,⁵⁹ and (iii) the Equity Funding cases where it is alleged that the profits were fraudulently overstated?⁶⁰ Had section 309 of the GCL

57. GCL, *supra* note 1, § 309(b).

58. *Beecher v. Able*, 374 F. Supp. 341 (S.D.N.Y. 1974). See also *Herbst v. Able*, 49 F.R.D. 286 (S.D.N.Y. 1970).

59. *In re Penn Cent. Sec. Lit.*, 347 F. Supp. 1327 (E.D. Pa. 1972), *modified in part, aff'd in part*, 357 F. Supp. 869 (E.D. Pa. 1973), *aff'd*, 494 F.2d 528 (3d Cir. 1974). See also *In re Penn Cent. Sec. Lit.*, 367 F. Supp. 1158 (E.D. Pa. 1973).

60. *In re Equity Funding Corp. of Am. Sec. Lit.*, 375 F. Supp. 1378 (Jud. Panel on Multidist. Lit. 1974).

been applicable, what of the duties of all those directors to obtain data upon which to base a belief of competence for all those who presented so many reports, budgets, forecasts, and opinions?

In dealing with outside experts, the director must believe that the matter is within the professional or expert competence of the outside expert.⁶¹ It would appear that the director will have an affirmative duty to receive information regarding the competence of the outsider. Perhaps a director might assume that each of the big eight accounting firms is in fact competent in auditing, and he may be safe in so doing; however, would he be safe in automatically transferring that assumption of competence to the tax or other management service departments of each of the big eight accounting firms? Those of us who practice law may find this an especially difficult problem to confront. What kind of information can a lawyer ethically and properly furnish to a board of directors to establish the necessary basis for the director to believe him competent in the matter? Must a director inquire of general counsel every time a different type of legal expertise is required? How is a director to know? Might the attorney be found liable for failure to advise the board that the attorney is not competent to handle a particular matter? Whether or not liable, a director should certainly make such inquiry.

A particularly perplexing problem is presented by section 309(b)(3) of the GCL. That provision permits the director to rely upon a committee of the board as long as he believes the committee merits his confidence. If a director votes for the election of a fellow director to a committee (suppose an audit committee), the court will almost certainly find that the members of the committee merited the confidence of the director voting for such election. If the courts will imply language in the provision to *require the belief to be continuous*, the director has a real problem. He must somehow receive information regarding the activities of the audit committee upon which to base any belief. What is a director to do if the audit committee is not meeting or not meeting frequently enough, or meeting frequently enough, but not gaining enough information? Under section 309 he cannot and should not rely upon the reports or opinions of the audit committee. Upon receiving a specific recommendation from the audit committee, must he indicate that he did not rely upon their recommendation but upon an independent evaluation, and is voting for it anyway? If he is voting

61. GCL, *supra* note 1, § 309(b)(1).

against the recommendation, must he indicate the basis for his no vote? Must he, during the course of the year, whenever he loses confidence, raise the issue at a board meeting and ask for a new election? Maybe a director should do all of these things, but in fact the vast majority of the directors will do none of the above. One does not serve on a board and "blow the whistle on" or otherwise unnecessarily embarrass fellow directors. The time honored means of solving the problem—the socially acceptable means of solving the problem—is to resign. Possibly one day the SEC will require proxy statements to contain more relevant data regarding directors, including the turn-over rate over a period of time.

V. CONCLUSION

The California Legislature has taken a giant step for directors. Consideration should be given to a redrafting of section 300 of the GCL, for it is in this section that the affirmative duties of directors are described with the use of words such as "manage," "powers shall be exercised by," and "under the ultimate direction" of the board. Section 300 should be made philosophically consistent with section 309. Finally, the references in section 309 to the duty of inquiry should perhaps be deleted. If such a duty exists without the language, then the language is not necessary; if such a duty does not exist without the language, then it should not be created if the goals and purposes of section 309 are to be fully achieved.

